EX PARTE OR LATE FILED

MOIR & HARDMAN
ATTORNEYS AT LAW

BRIAN R. MOIR

2000 L STREET, N.W., SUITE 512
WASHINGTON, D.C. 20036-4907
DIRECT DIAL: (202) 331-9852

FAX: 202-331-9854

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

April 16, 1997

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, N.W. -- Room 222
Washington, D.C. 20554

RE: Ex Parte Submission in CC Docket No. 96-45 and 96-262

Dear Mr. Caton:

Enclosed please find an outline of a proposed resolution to the universal service and access fees issues currently under consideration by the Federal Communications Commission (FCC). This proposal has been developed as a consensus approach by the major groups which represent the interests of residential and business telephone consumers groups[1].

This approach is markedly different than others which have been presented to the Commission in that it truly reforms access charges and fully funds universal service without raising current end user fees or creating new charges that are shifted, directly or indirectly, onto the backs of residential and business telephone customers.

These documents are being released today and we wanted you to have a chance to begin to assess the merits of this consumer/business consensus proposal. Please do not hesitate to call me with any questions about our proposal. We hope that it will be taken under serious consideration as you work on these important issues.

Sincerely,

B. R. M.

Brian R. Moir, Esq.
Counsel to the International Communications Association

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[1]American Petroleum Institute, Consumer Federation of America, Consumers Union, International Communications Association, Michigan Consumer Federation, and National Retail Federation

Consumer/Business Consensus Proposal for Access and Universal Service Reform

April 16, 1997

Supporters

American Petroleum Institute

Consumer Federation of America (CFA)

Consumers Union

International Communications Association (ICA)

Michigan Consumer Federation

Oregon Citizens' Board

National Retail Federation (NRF)

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I. Statement of Principles

A. Consumer/Business Consensus Principles for Access Reform

This proposal is in response to consumer/business understanding of the proposals being considered by some at the Federal Communications Commission (FCC), which would lead to numerous expanded or new end-user charges that would raise the total costs of telephony. Consumer and business user representatives decided to present the FCC with a practical, pro-consumer and pro-competitive pathway to resolution of the access proceeding based on the record evidence.

No new concepts or mechanisms are introduced as part of this plan that are not already part of the FCC's record. Instead, it uses the tools currently available to the FCC, information already in the record -- some of which has been before the FCC for some time, and provides a glide path to (1) complete resolution of the issue with total element long run incremental cost (TELRIC) -based pricing for access within 5 years and (2) fully fund universal service. This plan is not intended to benefit any one segment of the telecommunications industry or any company or group of companies. Rather, it is designed to maximize competition and deliver benefits to users - the primary goals of last year's telecommunications law..

It is important to note that the only way to remain true to the following principles and maintain a responsible balance between segments of the industry and consumers is to take this proposal as a package. Use of only bits or pieces of this plan will surely undermine some or all of the following principles and would, therefore, be unacceptable.

The principles embodied in the plan include:

- Consumer rates must come down at every step of the process
- No new end-user fees
- Initial cuts, which do not require resolution of TELRIC price for interstate access, are well-supported by the record
- TELRIC pricing of access as the end point
- Completely flow through of all net access reductions to customers
- Cuts do not imperil financial health of the Incumbent LECs (ILECs).
- Provide full funding for universal service, including schools and libraries
- ILECs gain quick transition to regulatory flexibility and the elimination of sharing

II. Proposed Resolution of the Docket

A. Consumer/Business Consensus Access and Universal Service Reform Proposal

Local competition cannot succeed without disbanding the existing system of bloated and hidden subsidies that the ILECs have employed since 1984 allegedly to support local service rates in high cost areas. In addition, residential and business consumers coalition are concerned that overall interstate access charges are currently set at a level far in excess of what is reasonably needed to subsidize local phone service in high cost areas, as well as telecommunications services for schools, libraries, and rural telemedicine. As a result, ratepayers are paying too much for long distance service. The Telecommunications Act of 1996 requires that the FCC decide by May 8, 1997, to create an explicit and competitively-neutral funding method for universal service. The Consumer/Business Consensus proposal is an effort to put that reform effort on a path that ensures that American consumers and businesses will benefit -- by providing ratepayers with overdue rate reductions, by facilitating local telephone competition, by lowering long distance rates, and by fully funding the universal service obligations that Congress mandated.

This proposal is our effort to focus the debate on the underlying issue -- whether the constituencies represented by the supporters of the Consensus Proposal -- the American telephone ratepayer -- will be better off as a result of FCC action. We believe this proposal is superior to any other suggestions for reform that have recently been under discussion at the FCC because, unlike other plans, this proposed solution creates real benefits. Furthermore, we believe this result can be achieved without requiring ratepayers to insure the ILECs against revenue losses from competition by creating any new flat, monthly "end user" charges.

Under our consensus proposal, interstate access charge and universal service reform would be completed over a 5 year transition period. Today's excessive access structure would gradually be replaced with one based on forward-looking economic costs, consistent with rate levels that would be found in a fully competitive market. At each step in the transition, ratepayers benefit from lower access charges that enable long distance rates to decrease. As access is reduced to cost, universal service obligations are transformed to fully fund the Federal-State Joint Board's recommended support for schools, libraries, rural health care, and an expanded lifeline program for low income Americans, as well as to create a competitively-neutral high cost fund mechanism that will allow all competing local providers to participate in high cost subsidies.

[The following narrative is intended to describe the detail surrounding a revenue effect chart appended at page 12.]

Universal Service Proposal

The Telecommunications Act of 1996 requires the FCC to complete action on its universal service cost proceeding by May 8, 1997. While it is clear that the FCC must adopt a decision --

and we would argue the decision must be significantly detailed to permit an understanding of the structure that will govern universal service in the future -- it is less clear that implementation must be immediate, or that all implementation details must be ironed out by the May deadline. For this reason, and based on press reports that the FCC may not be ready to adopt a detailed decision governing all aspects of implementation, we have presented a plan that provides the FCC with sufficient flexibility in how it implements universal service. The FCC has choice. It can implement high cost funding for the largest ILECs, along with funding for schools and libraries, on July 1, 1997. Or, it can adopt a plan now to implement its decision as late as July 1, 1998, if it believes that it needs additional time to size the high cost fund, for example. Regardless of which path it selects, the dollar amounts of access reductions exceed the increases in telephone rates of that will be needed to pay for subsidies to schools and libraries, producing a net benefit to ratepayers in each year.

The Consumer/Business Consensus Proposal would reform universal service by implementing a new high cost universal service fund on an interstate-only basis. Similarly, the subsidies for schools, libraries, rural health care telecommunications, and expanded lifeline would all come from the interstate jurisdiction. This feature of our proposal has beneficial effects -- e.g., that the FCC is operating on its strongest legal authority when it adopts an interstate-only solution. But the ability to pick up these costs in the interstate jurisdiction is *inextricably tied* to the FCC's decision to simultaneously lower interstate access charges so that true consumer benefits are realized.

Universal service would be implemented in several steps, as follows.

The first step consists of several significant reforms.

- Subsidies for schools and libraries, as recommended by the Federal-State Joint Board, are fully funded. The Joint Board recommended a subsidy of $2.25 billion per year to be funded by all interstate carriers. To determine the consumer effect of this new subsidy mechanism, we estimated that interexchange carriers will pay $1.994 billion of the $2.25 billion, with the remainder being paid by other providers of interstate services. In a system where access rates and long distance rates were otherwise flat, this could lead to an increase in long distance charges on ratepayers. As stated above, however, our plan ensures that ratepayers do not experience increases, since access will fall by a larger amount.

- The $300 million now given to the largest ILECs in the FCC's existing high cost fund would be deleted, and replaced with a competitively-neutral universal service fund that is sized based on forward-looking economic cost. To illustrate the fund size, we have utilized the Hatfield Model (Release 3.1) as the basis for the estimates provided.

- The large ILEC fund would be recovered entirely from interstate carriers, with interexchange carriers picking up the lion's share of the fund ($1.469 billion out of a total large ILEC fund size of $1.657 billion). High cost areas would be subsidized to $30 local rate level, which approximates the Joint Board's recommended benchmark set at the nationwide average revenue-per-line for residential and single-line business customers. This revenue would become part of the interexchange carriers' cost structure, and would be recovered as part of retail rates. It is therefore very important to this plan that interstate access charges, and long distance rates, decrease to a greater extent than the new universal service dollars that are required.

[It is important to recognize that states would have the flexibility to subsidize high cost areas to a rate level below $30, to the extent that they choose to do so in the intrastate jurisdiction. That the states are not required to bear any of the costs to the $30 level, and are not required to pick up any of the new costs for schools, libraries, rural health care telecommunications, and expanded lifeline, should provide them with the flexibility they need to institute their own state high cost plans.]

- Because large ILECs are now eligible to receive universal service subsidies for high cost areas to the extent that they retain customers in those areas, access is reduced by $1.169 billion [the $1.469 billion that interexchange carriers would now pay for high cost funding for large ILECs, less the $300 million in subsidy dollars now paid by interexchange carriers in the existing Universal Service Fund (USF)].

- Small ILECs may present special problems for universal service reform. In recognition of the possibility that there may be disparate impacts on small ILECs if immediate universal service reform were to occur, the solution we are proposing does not disturb existing FCC support mechanisms for this group until further study can be undertaken. The proposals impact on small ILECs is as follows:

  * Small ILEC interstate access charges continue at existing levels
  * Triple-Dial Equipment Minutes (DEM) weighting continues for the present
  * The existing High Cost Fund support remains
  * Long Term Support also remains in effect

  However, small ILECs should not be totally insulated from competition until these reforms occur. For that reason, the FCC should assign existing explicit subsidies for this group of carriers to the new universal service fund, and allow competitors that are competing against these small ILECs in their respective service territories, to become eligible to receive the funding on a per-subscriber basis through the transition to a more cost-based approach for small ILECs that will occur later in the 5 year transition plan.

The second step implements the expanded Lifeline plan.

- Today, states that are interested in receiving interstate subsidies to assist low income ratepayers can certify a state "lifeline" plan to the FCC, enabling their state ILECs to receive subsidies that lower monthly telephone bills and service installation costs (the program is known as "Link-Up."). Forty one states, the District of Columbia and the U.S. Virgin Islands presently participate in the existing plan.

- The Joint Board's expanded Lifeline recommendation is intended to spread Lifeline and Link-Up programs to **all** states, at an estimated cost of $600 million.

- Our proposal would phase in the expanded plan over a two year period, beginning on July 1, 1999, and fully funding the plan in the year 2000. This would provide ample time for state regulators to determine how implementation of this new low-income benefit will affect existing state-mandated programs and offerings, as well as time for the certification process to occur.

The third step implements subsidies for rural health care telecommunications.

- Based on our review of the FCC record, there is insufficient data to support adoption of a specific rural health care telecommunications subsidy at this time. It is our belief that the FCC needs to renew its efforts to determine what services should be provided, as well as to define the goals and purpose of this program, before proceeding to funding.

- We therefore recommend that the FCC announce in its universal service order that rural health care telecommunications subsidies will be implemented within three years, to allow for further study of this important issue.

- For the purposes of presenting a view of consumer effects on rural health care telecommunications, we have estimated that there could be additional costs of up to $400 million in the year 2000 when rural health telecommunications subsidies are initiated.

The fourth step in universal service reform is implementing a cost-based subsidy system for small ILECs.

- We have proposed that the FCC declare that on July 1, 2001, it will reform the existing subsidy mechanisms for small ILECs. For the purposes of showing revenue effects, we have relied on the Hatfield Model to size the fund necessary to subsidize small ILEC service areas to local rate levels of $30 a month, although the FCC could find some other mechanism to apply in sizing the fund based on forward-looking economic cost. The fund is entirely recouped in the interstate jurisdiction. Interexchange carriers will pay $1.335 billion of a total subsidy amount of $1.506 billion. That increased cost will be partially offset by elimination of the existing fund programs, which will produce a downward effect on access, together with other access reductions occurring that year, as described below.

Fifth, we propose that the school and library fund be modified on July 1, 2002, to reflect completion of inside wiring for these entities.

- The Federal-State Joint Board recommended that subsidies for schools and libraries include an amount necessary to provide inside wire to some portion of a building. Once schools and libraries are wired for Internet access, however, there is no public policy benefit in further taxing residential and business telephone ratepayers for ongoing wiring costs that will no longer exist.

- Our proposal therefore includes a decrease in charges to account for a "ramp down" in schools and libraries subsidies, to reflect only the ongoing cost of subsidizing telecommunications services.

Access Charge Proposal

While the promise of universal service reform benefits ratepayers by facilitating the emergence local telephone competition, and by fully funding subsidies to schools, libraries, rural health telecommunications, and low income subscribers, universal service reform does not by itself achieve the necessary principles which are core to these proceedings. Interstate access charges must be lowered, and lowered substantially, if American residential and business telephone consumers are going to benefit from the implementation of this new system. Below, we describe a year-by-year plan to lower access charges. Critical to the plan is the recognition that, in the end, interstate access rates must be set at forward-looking economic cost.

Year 1

The plan would commence on July 1, 1997 with the FCC relying on the existing record in the LEC price cap and access reform proceedings to reduce rates by a total of approximately $2.977 billion. Approximately $2 billion in reductions would come through reinitialization of interstate access rates down to a level which would yield the 11.25% return the ILECs were supposed to earn. The remainder would come from increasing the current productivity adjustment in the LEC price cap to 7.5%.

The FCC may choose to implement step one of the universal service proposal discussed above in Year 1.

Year 2

On July 1, 1998, the FCC would reduce the transport interconnection charge (TIC) to 20% of current levels, yielding an access reduction of $1.8 billion. In addition, there would be the annual benefit from applying the proposed productivity factor in the annual LEC access filings. The expected $249 million reduction would be applied to reduce rates across the board.

Alternatively, the FCC may choose to implement step one of universal service proposal in Year 2.

Year 3

By July 1, 1999, the FCC must complete its review of the forward-looking economic cost of access charges. This should allow the FCC ample time to consider the economic cost models now before it, and to identify the excess that is above cost by July 1, 1999. Access charges would be reduced by an amount equal to one-third of the remaining excess identified by the economic cost model that the FCC has selected. For the purposes of illustrating rate effects for our proposal, we have used the Hatfield Model (Release 3.1). We estimate that this would yield a reduction of almost $1.1 billion. Also at this point, the FCC would begin phasing in funding for the expanded Lifeline program at $300 million. This would make the plan's Year 3 net benefit to consumers $797 million.

Year 4

An additional one-third of the excess identified by the economic cost model would be eliminated on July 1, 2000, leaving one third of the excess remaining. The same reductions, just over $700 million in terminating and just under $400 million in originating access would be made. Additional expanded Lifeline program funding of $300 million would be put into place in Year 4, and the FCC would establish funding for the rural health care piece of universal service of about $400 million. For consumers, the net benefit from changes in this year would total $397 million in access reductions.

Year 5

The remaining excess would be removed from both originating and terminating access charges, bringing the cost of access down to economic cost levels by July 1, 2001. In addition, the FCC would institute an economic cost-based funding mechanism for universal service support for the rural LECs, based on the same $30 benchmark. When this new funding source is instituted, the existing support mechanisms - high cost fund, triple-DEM weighting, and Long Term Support would also be eliminated. Access charges would be reduced by the net change in support, a total of nearly $2.4 billion.

Out Years

LECs obtain **complete** pricing flexibility for interstate access services. In addition, since schools and libraries have been funded by some $11.25 billion during the preceding 5 years, the annual funding obligation would be reduced to $500 million. The reason for this change is that enough money to wire all classrooms and make necessary internal connections would have been collected by 2001. The ongoing costs for providing discounted service would be completely funded by $500 million in annual USF support.

Consumer/ Business Coalition Proposal

Date	Item	Revenue Effect ($M)	Universal Service Support ($M)	Consumer Benefit ($M)
7/1/97				
	Reinitialize rates for excessive earnings	-1,987		
	Set X to 7.5%	-990		
	Consumer Benefit			-2,977
97/98				
	New USF @ $30 benchmark	*1,469*	*1,657*	
	Remove current USF from large LECs	*-300*		
	Reduce access for large LEC USF	*-1,169*		
	Schools/Libraries	*1,994*	*2,250*	
	Consumer Effect[1]			*(1,994)*
7/1/98				
	Reduce TIC to 20% of current level	-1,799		
	X at 7.5%	-249		
	Consumer Benefit			-2,048
7/1/99				
	Terminating to TELRIC - First Step	-708		
	Originating to TELRIC - First Step	-389		
	Phase-in Expanded Lifeline[2]	300		
	Consumer Benefit			-797
7/1/00				
	Terminating to TELRIC - Second Step	-708		
	Originating to TELRIC - Second Step	-389		
	Phase-in Expanded Lifeline[2]	300		
	Rural Health Care	400		
	Consumer Benefit			-397
7/1/01				
	Terminating to TELRIC - Final Step	-708		
	Originating to TELRIC - Final Step	-389		
	USF @ $30 benchmark for rural LECs	1,335	1,506	
	Reduce access for rural LEC USF	-95		
	Remove Triple-DEM	-310		
	Remove current USF from rural LECs	-470		
	Remove Long Term Support	-460		
	Consumer Benefit			-1,097
7/1/02				
	Ramp Down School Funding[3]	-1,551	-1,750	-1,551
	Access Reductions, 7/1/97 - 7/1/02	-10,648		
	Consumer Benefit, 7/1/97 - 7/1/02	-6,872		

This set of changes could be implemented on either 7/1/97 or 7/1/98 and yield a net consumer benefit on those dates.

Footnotes

1 There will be an additional consumer effect of $444 million for the funding from other sources.
2 Expanded Lifeline will result in offsetting reductions of local service rates.
3 Assumes all one time costs have been paid for and recurring funding of $500 million annually is adequate to cover usage discounts.

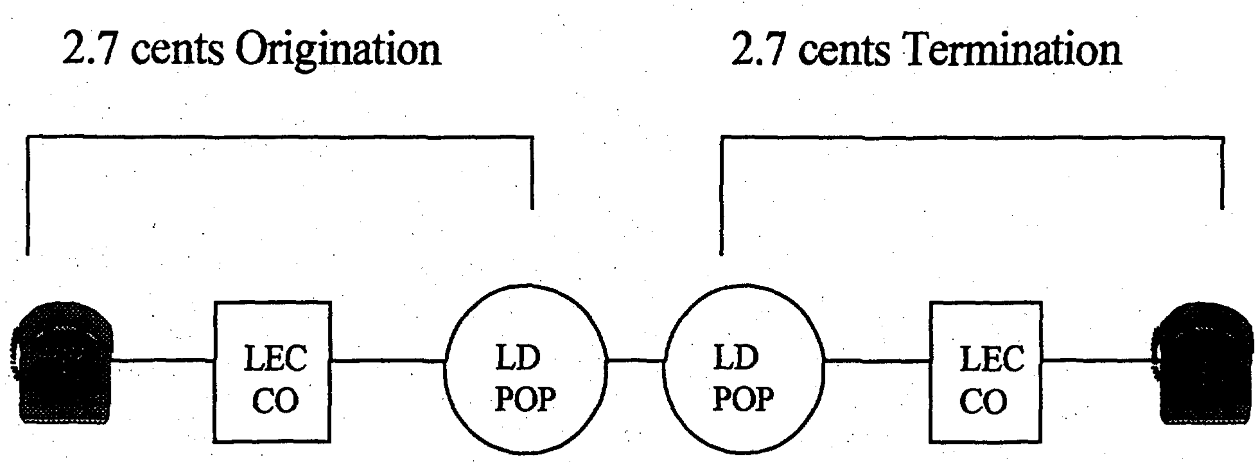
III. Legal and Economic Justification for the Proposed Resolution, by Each Principle

A. <u>Consumers Must Be Benefited at Each Step in the Transition to Full Implementation</u>

The three proceedings that make up the trilogy -- interconnection, universal service and access reform -- are each critical to achieving the ultimate goal of a fully competitive local telecommunications marketplace which provides the public with lower prices, increased innovation, and ever-improving service. However, only the access charge proceeding presents an opportunity for the FCC to provide a measurable consumer benefit -- lower long distance prices -- right now.

Access is a charge paid by long distance companies to local exchange carriers to originate and to terminate long distance calls. The FCC sets access charges for interstate traffic; the state commissions set access charges for traffic within state lines. The average rate that interexchange carriers pay to originate a call is 2.7 cents. These carriers also must pay an average of 2.7 cents to terminate each interstate call.

Average Interstate Originating & Terminating Access Charges



Interstate access charge levels are important because long distance carriers currently pay local exchange monopolies nearly 40 cents of every long distance revenue dollar. Interexchange carriers like MCI and AT&T estimate that the rates charged by the local exchange carriers for interstate access currently exceed their forward-looking economic cost by nearly 8 times. The FCC Chairman has recognized that "the difference between actual [access] charges and forward-looking cost based prices is measured in the billions of dollars." September 17, 1996, Speech by Chairman Hundt before the Media & Communications '96 Conference, p. 5. In another speech, this time before the National Association of Regulatory Utility Commissioners (NARUC), Chairman Hundt noted that "access is priced somewhere between 250-700 percent too high." February 25, 1997 Speech by Chairman Hundt before NARUC, p.6.

The interstate access reforms recommended in the consensus proposal benefits residential and business telephone consumers immediately without unfairly burdening any one segment of the industry. In the first year, consumer telephone rates will decrease by $2.97 billion dollars, if the Universal Service provisions outlined in the Coalition's proposal are applied in 1998. However, if the FCC decides to apply these Universal Service provisions in 1997, consumer telephone rates will decrease immediately by nearly a billion dollars. Under either circumstance, after five years, consumers' net rates will decrease by $6.87 billion. These reductions will be achieved even after funding universal service and the FCC's initiatives to wire schools, libraries and rural health care institutions and Lifeline. The consensus proposal allows for significant consumer rate reductions and provides nearly $4 billion in funding to meet these social objectives.

B. No New End User Fees That Raise Telephone Rates

Congress intended the Telecommunications Act of 1996 to result in increased competition, which would result in lower costs and lower rates for customers. It would be contrary to this intent if the result of the FCC's universal service and access reform proceedings were an increase in end user fees so as to protect subsidies that should be eliminated. In addition, shifting existing costs onto end user charges would serve to insulate these excessive charges from competition. This would ensure that rates remained higher than they should. Thus, the consensus proposal reflects no new end user charges.

Proposals that would either create new or increased end user fees, or shift current access revenues from per minute charges to per line charges that would likely be passed on to end users in the form of line items on our bills, are regressive. Such charges or end user fees would create a greater burden on low volume users like low-income consumers and those on fixed incomes and small businesses. This is the case because the long distance rate reductions flowed-through to low volume consumer and business customers would be far outweighed by the increases caused by new end user charges or per line assessments. It is anticipated that the FCC will require that the net long distance carrier savings that result from access charge/universal service reform are passed through to consumers on an equitable basis. This would require a showing by long distance carriers that: the average charge per minute has been reduced sufficiently to account for any net reduction in long distance access charge/universal service payments, and any net reductions are reasonable allocated to all categories of customers.

We want to make certain that all classes of consumers benefit from access and universal service reform and we believe our proposal assures such an outcome.

C. The FCC Has Authority and an Ample Record to Reinitialize Interstate Access Rates and Increase the LEC Productivity Factor

The first step of the plan can be accomplished by relying on the existing record in the LEC price cap and access reform proceedings, creating approximately $2 billion in reductions in the first year.

When the LEC Price Cap was created, the FCC did not make a specific finding that rates were just and reasonable or set at economically efficient levels.[1] The goal was for the price cap to bring rates down toward economically efficient levels over time.[2] In the initial price cap decision, the FCC recognized the need to periodically "true-up"or reinitialize LEC interstate access rates to reflect productivity gains and correct rates when necessary based on LEC earnings.[3] The price cap included provisions for "sharing" which provides that once certain earnings targets are reached, part and eventually all profits had to be shared with customers. The LECs have consistently achieved returns above 11.25%, and sharing has forced the LECs to reduce rates to consumers as a result. The LECs had an option to use a 3.3% or 4.3% productivity adjustment, with different amounts of sharing required under the different productivity adjustments. Most LECs chose the 3.3% productivity factor. The price cap decision has been upheld on appeal. See, 988 F.2d. 174.

When it was clear that rates were consistently yielding returns in excess of 11.25% under the price cap, the FCC initiated the Price Cap Performance Review in 1994.[4] In 1995, the FCC entered an interim order that was supposed to operate for one year while overall reform was completed. In that interim order, the FCC recognized that price cap LEC productivity far out paced the productivity factor in the price cap mechanism. As a result, the FCC ordered price cap LECs to recalculate rates based on a higher productivity adjustment retroactive to the initial price

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[1] "...we are not making a finding that existing rates are just and reasonable, but only that they are a reasonable starting point for price cap..." Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order 5 FCC Rcd 6786 at para. 241 (1990) (LEC Price Cap Order)

[2] Id. at para. 242. "While we agree that rates produced by a rate of return system can be uneconomically high, it is the ongoing operation of price cap regulation that will produce lower rates..."

[3] Id. at para. 389. "The FCC has stated its intention to consider price, quality of service, earnings, and technological progressiveness in the review of LEC performance under price caps." (emphasis added). See also, para. 394. "At [the] time [of performance review] we will evaluate all aspects of the price cap plan and of LEC performance."

[4] Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd 8961; March 30, 1995.

cap order from 1990.[5] The FCC rejected LEC claims that such an adjustment was a recapture of productivity gains[6] or retroactive rate making.[7]

- **Now Is The Time To Reform Price Caps.**

The overall access reform effort has been pushed off consistently until now. The LECs have pushed very hard to eliminate the sharing requirements. As part of the interim price cap decision, the LECs were given an option to take a 4.0%, 4.7% or 5.3% productivity adjustment. The highest productivity factor of 5.3% would allow the LECs to avoid sharing obligations. As expected, due to their consistently high earnings, virtually all of the large LECs chose this option and the trend of higher earnings has continued unabated.

Most recently, the ex parte filing by AT&T/Bell Atlantic/NYNEX advocated price cap reinitialization to 11.25%. Around the same time, the first information was filed as part of the annual access filing. This latest information shows that in 1996, the large LECs earned an average of 14.99%. This is yet another strong indication that current price cap levels are far too high and the productivity factor is too low and must be adjusted to yield reasonable returns.

- **The Price Cap Record Easily Supports LEC Productivity Adjustment of More Than 7.5%**

Several documents have been placed on the record which demonstrate that the actual productivity of the price cap LECs is in the range of 10%. These include Total Factor Productivity studies prepared by ETI and Ad Hoc Telecommunications Users Group economists. In addition, a coalition of residential and business long distance users and long distance companies, Customers for Access Rate Equity (CARE) also performed an analysis of the LEC

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[5]Id. at para. 247. "Specifically, for each year that a LEC elected an X-Factor of 3.3 percentage points, we conclude that the X-Factor for that LEC was 0.7 percentage points too low. Therefore, we require LECs to multiply their current PCIs [Price Cap Indices] for the current common line basket, traffic sensitive basket, and trunking basket by a factor equal to the following equation: 1 - (0.007n) where n is the number of years the LEC elected to use an X-Factor of 3.3 percent. We find this reinitialization necessary for the trunking basket as well...)

[6]Id. at para. 252. "We disagree with USTA and others who characterize a one-time adjustment to the rates of price cap LECs as a recapture of productivity gains...The one time adjustment merely ensures that, in the future, higher earnings must be attained through actual improvements in productivity and will not continue to accrue as a result of administrative error."

[7]Id. at para. 253. "...the rule against retroactive rate making does not preclude the FCC from looking back, as we have done here, at the results of past applications or our rate formulas in order to determine whether those formulas will continue to produce reasonable rates in the future."

financials illustrating that a 10% actual productivity factor for the price cap LECs was the "break-even" point that would lead carriers to select the 5.3% productivity adjustment option. This analysis was put on the record in the price cap proceeding after the interim price cap order was adopted.

Even the LEC studies, if done properly, would show productivity in excess of 7.5%. The Total Factor Productivity (TFP) studies performed by the LECs incorrectly exclude the input price differential and do not limit their analysis to the interstate services which will be regulated under price caps. AT&T performed a TFP study correcting these two errors and found the LEC productivity differential to be 8.5%. This result is reinforced by the choice of productivity factor made by the LECs. As previously demonstrated by MCI, for the LECs to have chosen a 5.3% productivity factor, as most of them did, they would have had to expect to achieve productivity in excess of 8.4%.

- **Reductions in TIC and Terminating Access Can be Done Before TELRIC Studies are Complete**

The FCC has failed to demonstrate that the transport interconnection charge (TIC) is cost justified. In Competitive Telecommunications Association v. FCC et.al.,[8] the Court remanded back to the FCC the decision creating the TIC. The Court found that the FCC "must either establish a cost-based alternative to the [T]IC, or provide a reasoned explanation why a departure from a cost-based system is necessary and desirable." Since the FCC will not be able to demonstrate that the TIC is necessary it would be appropriate and pro-competitive to apply per minute access reductions to ultimate elimination of the TIC. While the FCC may determine that it needs a more complete record before eliminating the TIC, both NYNEX and Bell Atlantic, in their joint ex-parte proposal with AT&T on access reform filed April 4, 1997 admit that at least 80% of the current TIC is unjustifiable and should be eliminated. This would be an important first step while the FCC builds a more complete record on which to eliminate the TIC completely.

- **Subsequent Reductions Based on TELRIC Methodology Are Authorized By Law and Would Not Constitute a Taking.**

Both the 1996 Telecommunications Act itself and the implementation of it by the FCC and the states mandates moving access charges toward forward-looking costs. This is the price a competitive market would yield and the FCC's regulations as the access market is opened to competition should set rates at this level. Competition cannot develop properly if any one segment of the industry is benefiting from large, uneconomic subsidies as is the case with inflated access charges. Leaving these overcharges in the hands of the ILECs will allow them to delay competition in the local market by strengthening their grip on the local market while permitting them to enter the long distance market once the competitive checklist is met with an unfair competitive advantage. For consumers, at minimum, this means bills that are too high.

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[8] 87 F.3d 822 (1996)

Moreover, the 1996 Act has also opened up long distance to competition from the RBOCs. In order to prevent unfair competition in this market, it is essential that the RBOCs not be allowed to charge higher access charges to competitors than they will incur in providing access to themselves or an anti-competitive price squeeze is inevitable.

Moving access prices to TELRIC would by no means constitute an unconstitutional "taking" under the Fifth Amendment.[9] The FCC did an excellent job laying out exactly why this argument is unsustainable in its brief to the 8th Circuit in appeal of the Interconnection Order.[10] In the brief, the FCC points out that the Supreme Court has found that "a state scheme of utility regulation does not 'take' property simply because it disallows recovery of [prudently made] capital investments that are not 'used and useful in service to the public.'" Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989). The same Court notes that reproduction cost rate making has always been a permissible form of regulation that "gives utilities strong incentives to manage their affairs well and to provide efficient service to the public." Id. at 309. The FCC also points out that it is free to change rate making methodologies without unconstitutionally undermining reasonable investment-backed expectations because regulated companies have no vested interest in any particular regulatory regime. See e.g., General Tel. Co. of the Southwest v. United States, 449 F.2d 846 (5th Cir. 1971).

The FCC also points out in its 8th Circuit brief that the large ILECs have been operating under "price cap" rules at the federal level and the link between rates and historic or embedded costs has been weakened or perhaps even severed. Furthermore, the FCC points out that the record demonstrates that a majority of the investments on ILEC books were made after price caps were implemented.[11] In any case, the FCC points out, if any burden at all is placed on ILECs, it would not be a taking. TELRIC-based rate making is intended to replicate the rates that would be charged in a competitive market. Given that the Fifth Amendment does not insulate carriers from competitive losses, neither should it protect them from having to charge competitive rates.[12] TELRIC rates for access in general and this proposal in particular strikes the proper balance between the interests of consumer and investor, which is the essence of the rate-making process.[13]

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[9]U.S. Const. Amend. V ("nor shall private property be taken for public use, without just compensation").

[10]See, Brief of Respondents Federal Communications FCC and United States of America, No. 96-3321, United States Court of Appeal for the Eighth Circuit, December 23, 1996.

[11]See, Reply Affidavit of W. Baumol, et. al., at para. 7 (App. 354); Affidavit of L. Selwyn & P. Kravtin, at para. 5 (App. 295-96), and accompanying ETI Study at 18-22 (App. 330-334).

[12]See, Public Service Comm'n of Montana v. Great Northern Utilities Co., 289 U.S. 130, 135 (1933).

[13]See, Federal Power FCC v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944).

D The FCC Must Determine That Access Charges Should Reflect Total Element Long Run Incremental Cost (TELRIC)

The goal of the consensus proposal plan is to provide a path to economic cost for access without increasing current end user charges or creating new ones. The proposal's interstate access reform plan would be a 5-year transition from current rates to forward-looking economic cost. The Chairman of the FCC has recognized that "[o]nly forward-looking cost concepts are consistent with a competitive market, because any other approach either makes the new entrant pay a tribute to the incumbent for the privilege of entry, or creates disincentives for the incumbent to invest in the network." September 17, 1996, Speech by Chairman Hundt before the Media & Communications '96 Conference. p. 4.

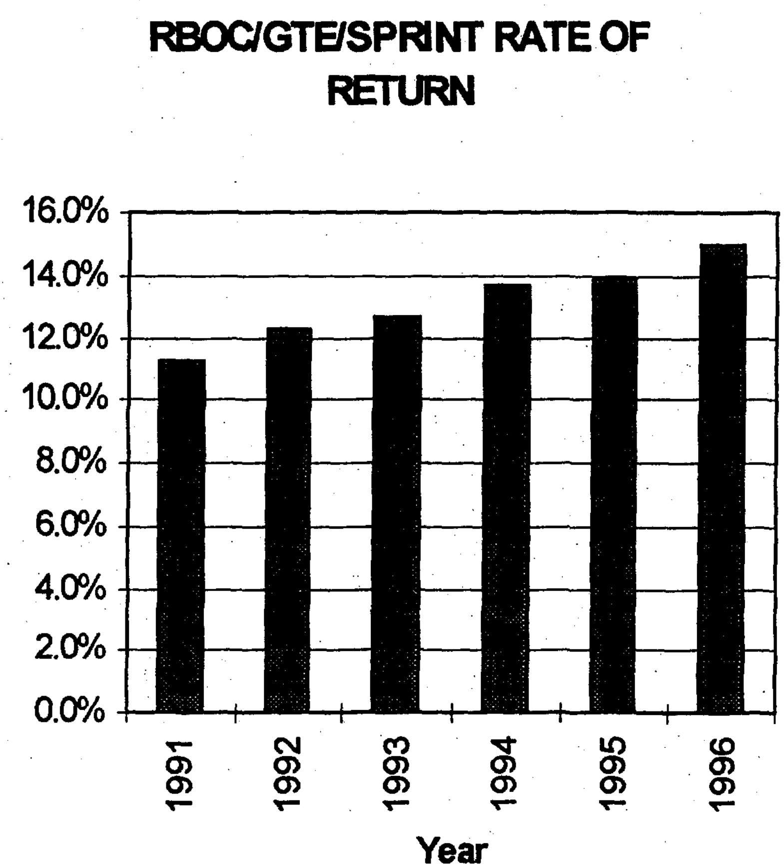
In the Interconnection Order, the FCC determined that total element long run incremental cost, or TELRIC, is a forward-looking, cost-based pricing standard, that allows incumbent LECs to recover a reasonable return on investment, recover joint and common costs, while taking into account changes in input prices and technologies, incremental costs, and competitive markets. In short, it emulates competitive market prices. In addition, the Federal/State Joint Board on Universal Service has endorsed the forward-looking costs to size the Universal Service fund.

It is important that the FCC explicitly adopt TELRIC in this proceeding as the basis for determining interstate access charges. First, it would ensure a fundamental consistency between access rates and local interconnection rates, significantly reducing the risks of arbitrage and inefficient investments. Second, as the FCC already determined in the Interconnection Order, TELRIC-based rates allow the incumbent local exchange carriers the opportunity to recover a reasonable return, without creating an environment in which new entrants are required to fund their largest competitors' -- the LECs -- war chest. Thus TELRIC is necessary to maximize competition.

The consensus plan includes significant reductions in the first year using price cap mechanisms with further reductions down to TELRIC coming after the FCC has chosen a forward-looking cost model. The model would need to be in place and operational by July 1, 1999. The plan would not lead to rate increases or new or increased end-user charges. While the FCC may not be able to identify exactly what the TELRIC price of access is today, it should explicitly adopt the TELRIC pricing principle as a goal, and move toward that goal within two years. Adopting TELRIC as the basis for access charges is consistent with FCC precedent, offers increased certainty in the market place, and sets guidelines that state regulators can follow, if they desire.

E. The Consensus Plan's Proposed Cuts Do Not Impair the Financial Health of the Incumbent LECs

In 1996, the Regional Bell Operating Companies (RBOCs), GTE, and Sprint reported their highest earnings as a group since the FCC adopted price cap regulation of interstate services in 1991. As the graph below depicts, despite increased price cap productivity adjustment, over $1 billion of monopoly "excess profits" that the FCC ordered these carriers to return to access customers in 1995, and the passage of the 1996 Telecommunications Act, these local exchange carriers continue to earn increased levels of profit.



The FCC has determined that 11.25 percent is a reasonable rate of return for price cap services. However, since 1992, these local exchange carriers have earned more than $3.8 billion above this rate on interstate price cap services. The table below shows that the RBOCs, GTE, and Sprint are clearly earning more than they need to recover their investments. Moreover, these tables show that the current price cap system must be corrected, as it yields ever-increasing excess profits for the incumbent local exchange carriers.

Rate of Return

	1991	1992	1993	1994	1995	1996
RBOC/SPR/GTE	**11.2%**	**12.3%**	**12.7%**	**13.7%**	**13.9%**	**15.0%**
Ameritech	12.1%	12.1%	13.9%	12.5%	16.8%	18.3%
Bell Atlantic	12.1%	11.6%	13.0%	13.9%	13.7%	11.3%
BellSouth	12.5%	12.8%	13.5%	19.3%	15.8%	16.2%
NYNEX	7.9%	13.7%	13.5%	11.8%	12.1%	13.7%
Pacific Telesis	11.8%	13.0%	13.0%	15.4%	15.2%	17.9%
SBC	10.6%	11.9%	12.4%	12.4%	13.4%	11.6%
US West	11.7%	11.9%	13.0%	12.5%	11.6%	13.6%
Sprint	11.8%	12.6%	13.4%	16.6%	18.8%	19.7%
GTE	11.1%	11.0%	9.9%	11.7%	12.1%	17.6%

Notes: 1991, 1992, 1993 are based on ARMIS
1994, 1995, 1996 are based on Initial 492A Forms

Nevertheless, incumbent local phone monopolies are concerned that FCC action resulting in immediate access charge reductions will hurt their stock values. This concern is without support. As is demonstrated below, many Wall Street analysts have already factored in significant access rate reductions, and continue to look at the incumbent local phone companies' stocks in a favorable light:

CS First Boston stated on March 27, 1997 that:

> [M]ost investors seem to be aware of a likely cut in access charges (net of universal service collections) of $1 to $2 billion. No one seems to be clinging to the hope that access reform will be a "revenue neutral" event as some were espousing earlier.

Morgan Stanley stated on April 3, 1997 that:

> We have assumed the RBOCs will be subject to a $2 billion up front cut in access, net of universal service."

Merrill Lynch stated on April 3, 1997 that:

> With current P/E's averaging 12.3x '98 EPS (a 25% discount to the S&P 500's), we believe RBOC/GTE shares are overly discounted for the regulatory uncertainties. The group offers significant investment attraction given above market EPS growth, over 2x S&D dividend yields, and more defensiveness than the average company."

Smith Barney stated on February 3, 1997 that:

> In our opinion, the telcos are 30% undervalued presently. . . [T]he telco universe has already experienced the correction that we believe other sectors of the economy will experience when their growth is called into question.

Lehman Brothers stated on January 19, 1996 that:

> Universal Service and access reform will be designed to prevent significant profit shifts between RBOCs and IXCs. Any changes will be phased in over 2-5 years and probably would not result in a net revenue reduction to the RBOCs beyond the historic access reduction of $500 million per year."

Additionally, as recently as April 11, 1997, Goldman Sachs issued "First Calls" rating SBC, US West, Ameritech, Bell Atlantic, and BellSouth as "Market Performers." This rating is despite Goldman Sachs' recognition of SBC's "increasing vulnerability to competition, especially in highly-urban California," and that US West's "costs and access prices are among the highest in the nation, making it more vulnerable than it otherwise would be to competitive inroads and FCC-mandated access reform."

The FCC should not be concerned that local phone company stock values will plummet if immediate access reductions are ordered for purposes of setting regulatory policy. Even so, Wall Street recognizes that current access rates are inflated, and expects the FCC to order significant access reductions. The stock prices of incumbent local telephone companies reflect these expectations.

F. The FCC has Authority and an Ample Record to Adopt the Universal Service Aspects of the Proposal

The Telecommunications Act of 1996 requires the FCC to initiate a single proceeding to implement the recommendation from the Joint Board and to complete that proceeding by May 8, 1997. Further, the Act states that the rules established by the FCC shall define the services supported by the federal universal service fund and establish a specific timetable for the implementation of universal service. The Act also requires that universal service support by sufficient, explicit, and funded by interstate carriers. The instant proposal complies with these requirements.

In this proposal, all elements of universal service are funded at sufficient levels; support would be explicit; and support would be funded by all interstate carriers based on interstate revenues. This eliminates a potential area of conflict between regulatory authorities at the federal and state levels. By funding universal service, including schools and libraries, rural health care and expanded Lifeline programs out of interstate revenues, the FCC can avoid a potential jurisdictional fight with the states. Furthermore, it gives states the flexibility to augment the federal universal service program if they so choose. Most importantly, there is ample evidence on the record to support adoption of the proposal.

Under this proposal, the FCC would adopt the recommendation of the Joint Board and find that universal service support should be based on the forward-looking economic cost of providing supported services as determined by a proxy model. The size of the federal fund would be based on a $30 benchmark rate (a lower benchmark could make purely interstate funding prohibitive), which is in the same range as Joint Board recommendation. Not only was this finding adopted by the Joint Board in its Recommended Decision, it is supported by a majority of commenters, including local exchange carriers. However, because there are still a number of concerns with the two primary models on the record--Hatfield 3.1 and the Benchmark Cost Proxy Model-- and with the effect of the models for rural areas, the use of the proxy models should be implemented over the following time line: support for large LECs would be based on the model effective July 1, 1998 and support for rural LECs would be based on the model effective July 1, 2001.

Until support is determined based on the model, carriers would continue to receive the support that they receive today. Thus, until July 1, 1998, large LECs would receive approximately $300 million in support through access charges. Similarly, rural LECs would continue to receive support on the same basis and for all lines, as they do today, until July 1, 2001, at which time, support for rural LECs would be based on the proxy model. Once support is based on the proxy model, triple DEM weighting, long term support and the universal service fund would be eliminated and instead support determined by the proxy model would be funded through the federal universal service fund.